Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Peace	Analyst:	Norm Catelli	Bill Number:	SB 1662
Related Bills:	See Legislative History	Telephone:	845-5117	Introduced Date:	2//21/2002
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Gain From The Sale Or Exchange Of Capital Assets Held More Than One Year/Reduced Tax Rates

SUMMARY

This bill would reduce capital gains tax rates for personal income taxpayers for taxable years 2002 and 2003.

PURPOSE OF THE BILL

It appears that the purpose of this bill is to encourage investment in capital assets.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would become effective immediately upon enactment and would be operative for taxable years beginning on or after January 1, 2002, and be repealed by its own terms on January 1, 2004.

POSITION

Pending.

ANALYSIS

FEDERAL/STATE LAW

The term "capital asset" is defined in the Internal Revenue Code (IRC) by exclusion. Specifically, IRC Section 1221(a) states that the term "capital asset" means property held by the taxpayer, whether or not used in connection with a trade or business, but does not include:

- Property that is properly includible as inventory in the hands of the taxpayer or property held by the taxpayer for sale to customers in the ordinary course of the taxpayer's trade or business,
- Property used in the taxpayer's trade or business that is depreciable or amortizable under IRC Section 167, or real property used in the taxpayer's trade or business,
- Copyrights, literary, musical, or artistic compositions, or similar assets held by the taxpayer due to the personal efforts on the taxpayer,

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- Accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or for property sold,

- Certain publications of the United States Government,

- Certain commodities and derivative financial instruments held by a taxpayer who is a derivative dealer,

- Certain hedging transactions, and

- Supplies that are used or consumed by the taxpayer in the ordinary course of the taxpayer's trade or business.

In addition to defining "capital assets", IRC Sections 1201 through 1257 provide rules for identifying holding periods, and determining the gain or loss from the sale or exchange of a capital asset. Complex rules allow non-corporate taxpayers to apply maximum tax rates from 8% to 28% to the taxation of the gain.

Additionally, holders of small business stock, a special security subject to rules designed to encourage small business, may exclude 50% of the gain on the sale of the stock. For alternative minimum tax (AMT) purposes 42% of the excluded gain is considered a tax preference item.

Federal law also allows an exclusion of the capital gain from the sale of a principal residence, subject to certain limitations. An individual may exclude up to $250,000 of gain, while a married couple filing a joint return may exclude up to $500,000.

California law generally follows federal law with the following exceptions:

- ➢ Capital gains are taxed at ordinary income tax rates,
- ➢ Small business stock exclusion rules require certain California activity, and
- ➢ 50% of the excluded small business stock gain is a tax preference item.

<u>THIS BILL</u>

This bill would tax capital gains at 2.325% for:

- Single (or married filing separate) taxpayers with a taxable income equal to or less than $29,850[1],
- Married taxpayers with a taxable income equal to or less than $59,700, and,
- Head-of-household taxpayers with a taxable income equal to or less than $43, 473.

The capital gain rate would be 4.65% for taxpayers whose taxable income is greater than the 2.325% threshold amounts. This section would not apply to collectibles (e.g., works of art, coins, bullion) and certain gains related to certain depreciable real estate used in a business or held for investment. This bill would be repealed by its own terms on January 1, 2004.

[1] Taxable income amounts are indexed for 2001 @ R&TC 17041(h).

IMPLEMENTATION CONSIDERATIONS

As this bill is written, the personal income tax forms will have to be revised to separate the components of “taxable income” to accommodate the different rates for capital gain income and other income. This would result in higher costs for both the form and the booklets that include the form. Added complexity would increase telephone calls to the call center. Computer programming to the personal income tax processing system may be required. Also, the extra pages included in the tax returns would result in increased storage costs.

LEGISLATIVE HISTORY

AB 1842 (Campbell; 2001-2002) was introduced on January 28, 2002, and would allow 50% of any gain from a capital asset held more than one year to be excluded from income by taxpayers subject to the PITL or Corporation Tax law. AB 1897 (Zettel; 2001-2002) was introduced February 6, 2002, and contains the same language as AB 1842. Both bills are in the Assembly Revenue and Taxation Committee.

AB 7 (Campbell; 1999-2000), SB 37 (Baca; 1999-2000), and SB 34 (Brulte; 1999-2000) would have excluded from gross income any gain from the sale or exchange of a capital asset held for five years or more. These bills were held in the relevant Revenue and Taxation Committees.

AB 9 (Campbell; 1997-1998) would have excluded 29% of any gain if the capital asset was held for less than five years and 36% of the gain if the capital asset was held for five years or more. This bill was held in the Assembly Revenue and Taxation Committee.

OTHER STATES’ INFORMATION

*New York, Illinois, Michigan, and Minnesot*a have personal income tax laws that begin with federal adjusted gross income (AGI), which results in those states conforming to favorable federal treatment of capital gains reflected in the federal AGI. These states do not otherwise provide favorable treatment to capital gains.

Massachusetts has a freestanding personal income tax system that treats capital gains favorably, on a sliding scale based on holding period with taxation eliminated on capital assets held for six or more years.

The laws of these states were reviewed because their tax laws are similar to California’s income tax laws.

FISCAL IMPACT

To implement this bill, the Schedule D, California Capital Gain or Loss Adjustment, and instructions would need to be modified. Currently, the Schedule D is a half page and increasing the size would probably cause it to be at least one full page or even two pages, if it mirrored the comparable federal form. The increased size and complexity of the form would result in higher production costs, higher computer programming costs, increased telephone calls to the call center, and ultimately, increased storage costs for the tax returns. These factors could significantly impact the department’s costs.

ECONOMIC IMPACT

Revenue Estimate

This bill would result in revenue losses as follows:

Estimated Revenue Impact of SB 1662 As Introduced February 21, 2002 Effective for taxable years BOA 1/1/2002 Enacted after 6/30/2002 $ Millions		
2002-03	2003-04	2004-05
-$1,217	-$1,059	- minor

This estimate does not account for changes in employment, personal income, or gross state product that could result from this measure.

Revenue Discussion

The above revenue impact was estimated as follows.

First, the PIT tax liability under the current law was simulated based on a sample of PIT tax returns for the 1999 tax year.

Next, PIT tax liability under the proposed law was simulated using the same data sample. The later simulation computed tax liability in two steps. In the first step, qualifying net long-term capital gains were excluded from taxable income, and tax liability was recomputed. In the second step, the specific tax on qualified net long-term capital gains was calculated and added to the tax liability computed in step one.

Finally, revenue loss due to reduced tax rates on capital gains for 1999 is estimated as the difference between the two simulated tax liabilities. The simulated 1999 revenue loss was extrapolated to future years based on the Department of Finance December-2001 projected annual growth rates of PIT capital gains.

ARGUMENTS/POLICY CONCERNS

Existing federal and state laws provide for an AMT liability, which ensures that taxpayers with substantial economic income and credits, deductions, and other preference items do not completely escape taxation. Legislation creating IRC Section 1202 and R&TC Section 18152.5 also created AMT tax preferences for a part of the excluded income. Consideration should be given to recognition of the reduced tax rate as a tax preference item for AMT purposes.

The inclusion of a prospective operative date applying to assets sold or exchanged after a future date may be appropriate as an inducement for future action or behavior.

This proposal allows the favorable tax rates for capital gains to be used in addition to the small business stock exclusion and the principal residence exclusion. For example, if a shareholder sold qualified small business stock for a gain of $500 (pursuant to R&TC Section 18152.5), 50% of the gain would be excluded from income and the balance would be subject to the favorable rate. Similarly, if a taxpayer who is single sold his/her personal residence and qualified for the R&TC Section 17152 exclusion, the gain in excess of $250,000 would be subject to the favorable rates. Consideration should be given to an amendment if the author does not intend this “double” benefit.

This bill would tax the capital gain income of taxpayers in the lower brackets at a higher rate than their other income is currently taxed. In addition, the capital gains rate for these taxpayers would also be higher than under current law. For example, for taxable year 2001, a taxpayer who files "single" with a taxable income of $13,625, under current law, would have all income, including capital gain income, taxed at the normal rate of 2%. This bill would require that the taxpayer’s capital gain income be distinguished from other income and be taxed at 2.325%.

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